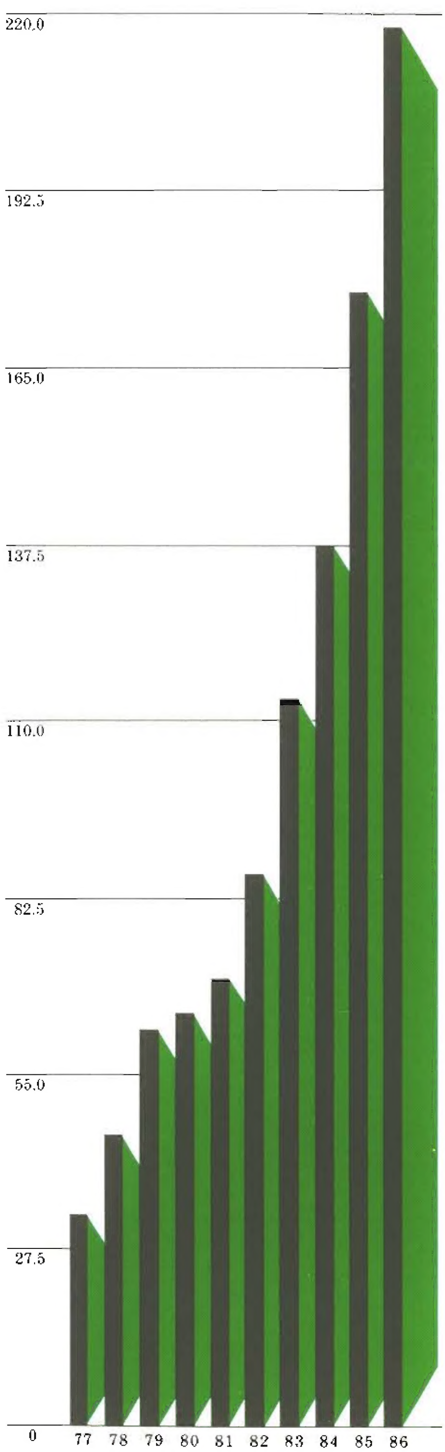
FAMILY DOLLAR
1986 ANNUAL REPORT

MARKET RESEARCH

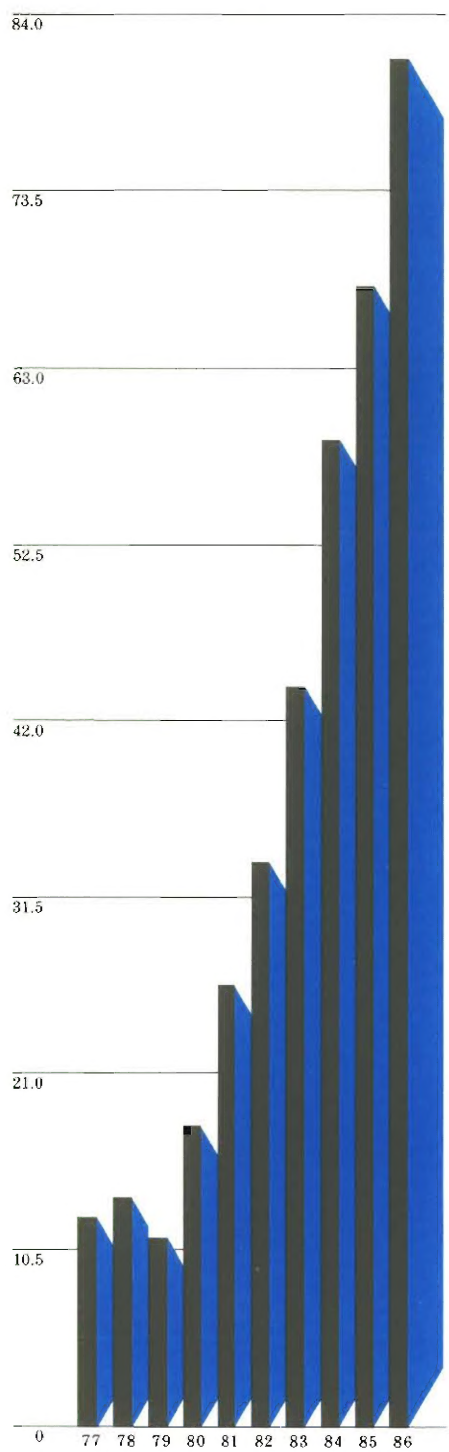
A Continuing Focus on Our Customers

FAMILY DOLLAR

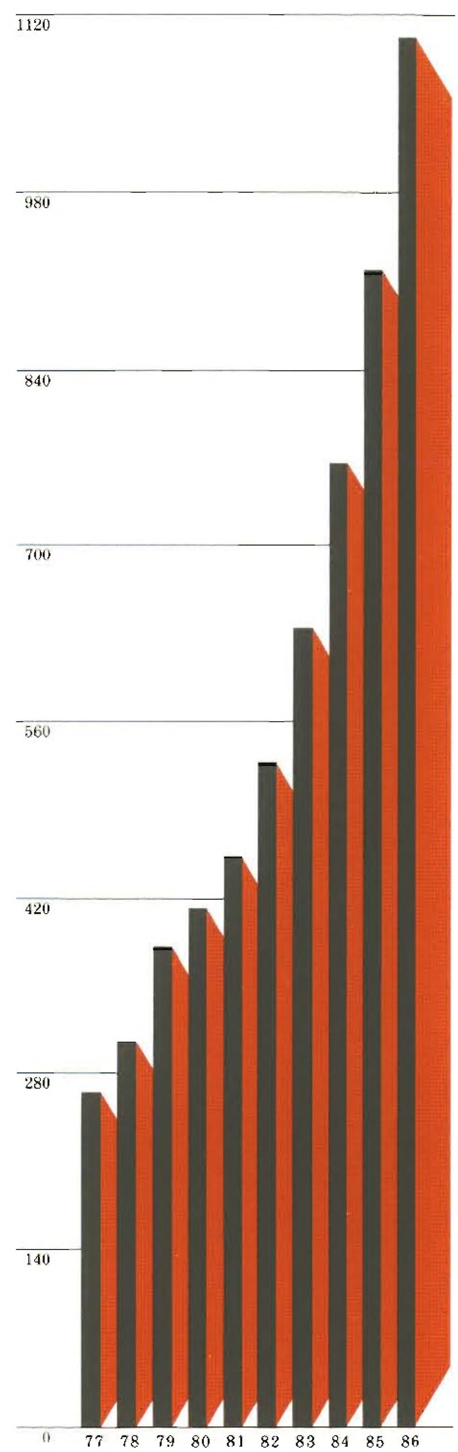
Total Assets
(Millions of Dollars)



Working Capital
(Millions of Dollars)

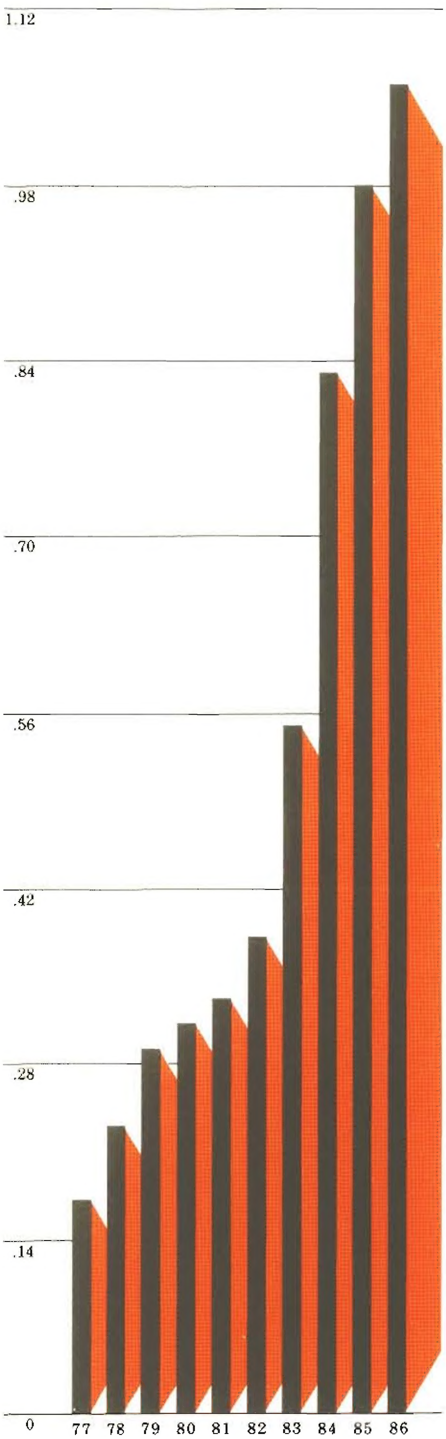


Number of Stores

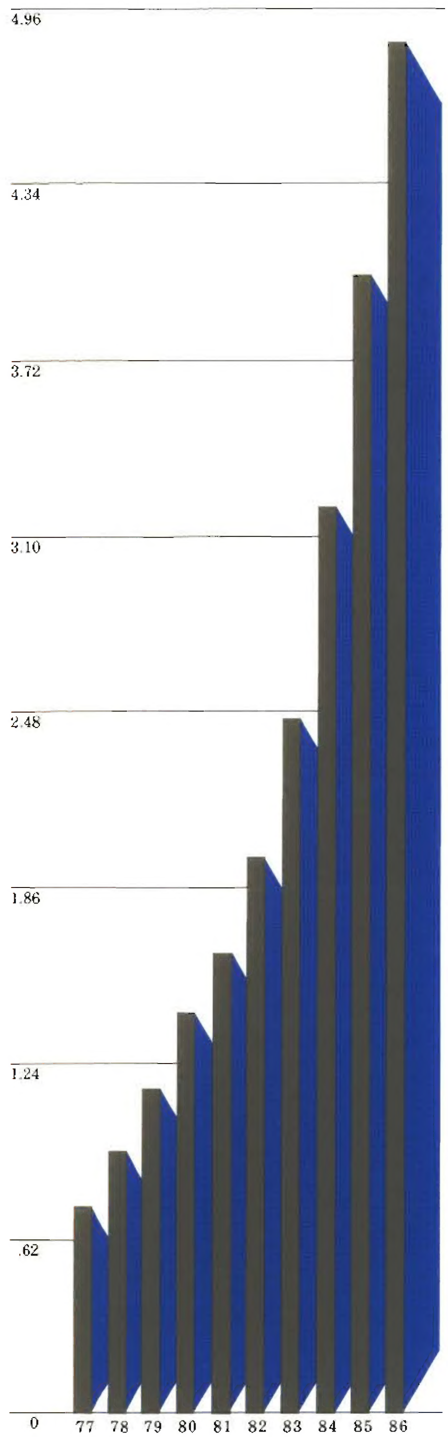


Ten Years of Growth

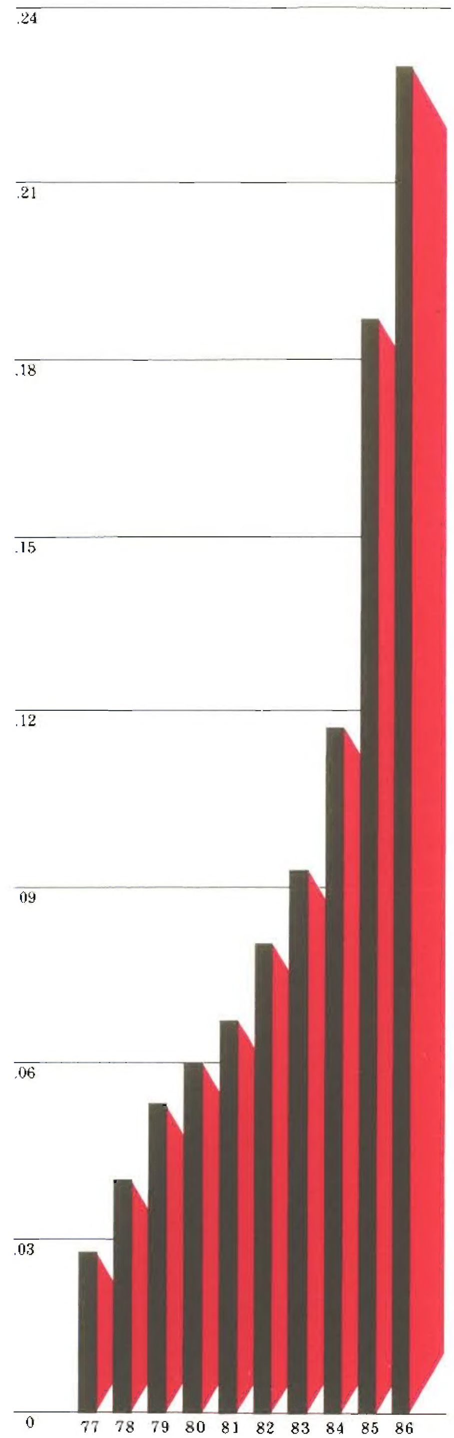
Net Income Per Common Share
(Dollars)



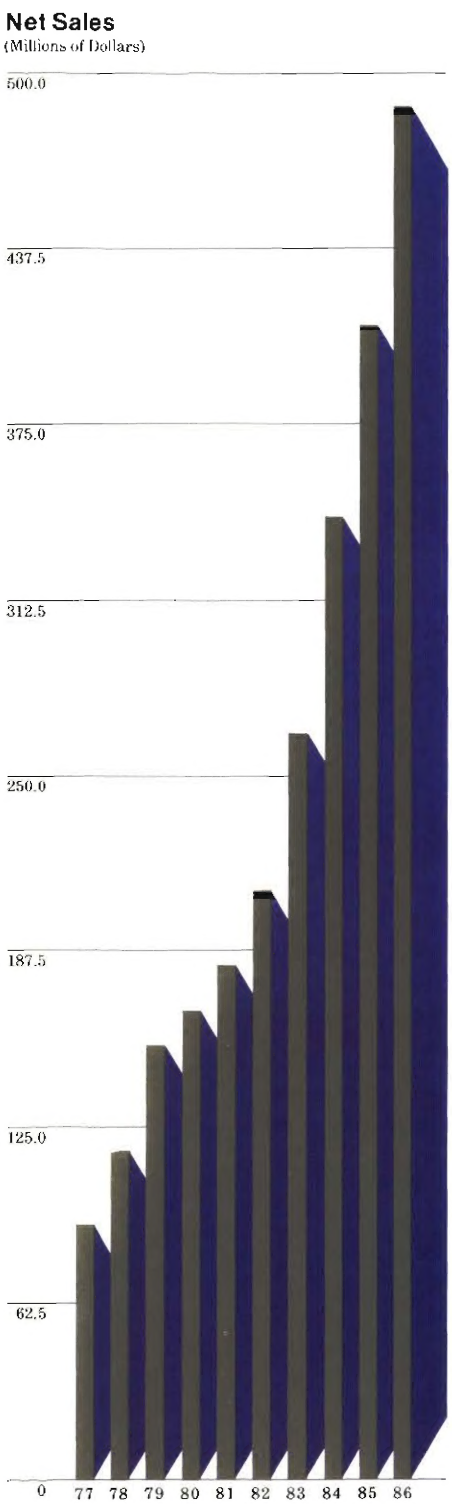
Book Value Per Common Share
(Dollars)

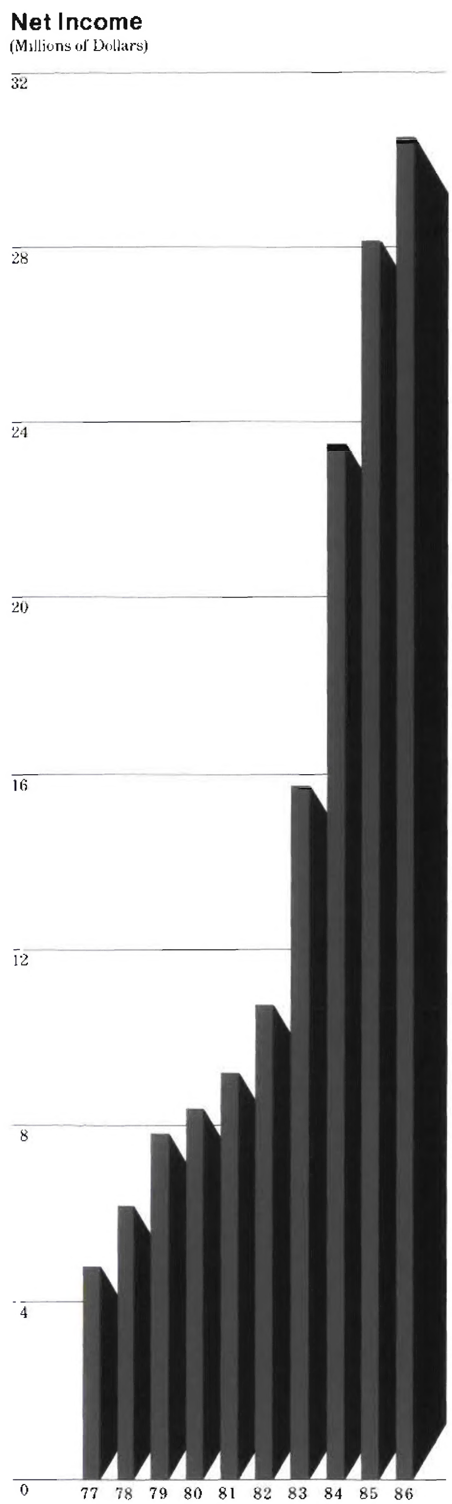


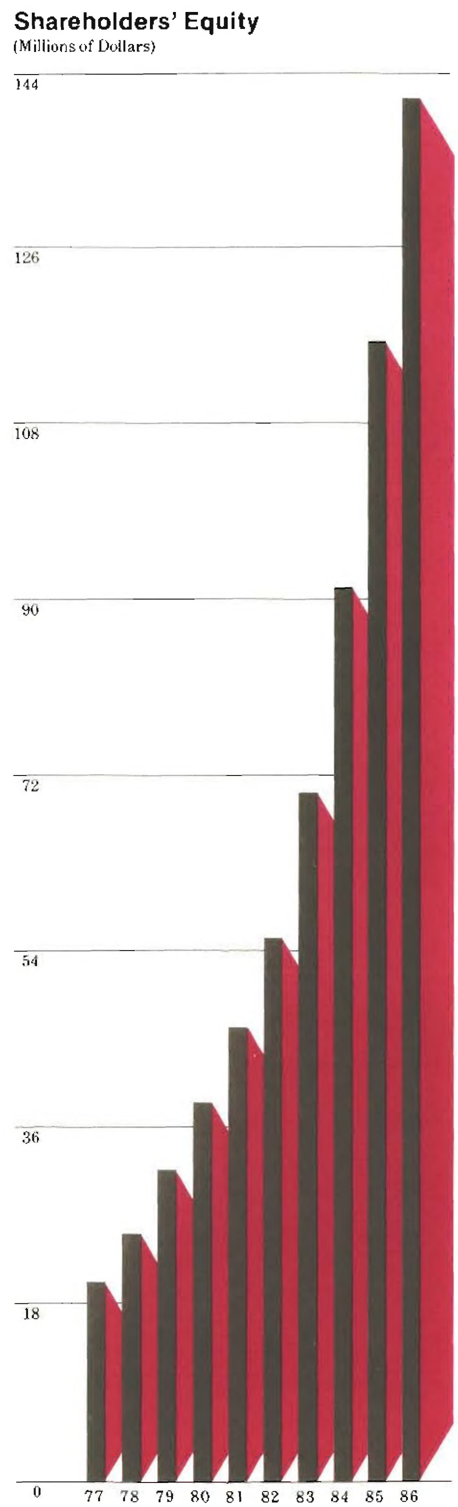
Dividends Declared Per Common Share
(Dollars)



"Family Dollar has continued to build upon its consistent record of growth in sales and earnings."







"... Family Dollar again achieved record sales and earnings while aggressively pursuing an expansion program that positions the Company for future profitable growth."

To Our Shareholders

Fiscal 1986 was a year of continued growth. In a difficult retail sales environment, Family Dollar again achieved record sales and earnings while aggressively pursuing an expansion program that positions the Company for future profitable growth.

Highlights

The year ended August 31, 1986, was highlighted by:

- Sales gains of 19% and earnings increases of 9% above the record sales and earnings in fiscal 1985
- Net return on sales of 6.3% and shareholders' return on average equity of 23.7%
- Cash dividends per share of Common Stock increasing 23% above the dividends declared in fiscal 1985
- A record 187 new stores opened, including the first stores in Illinois, Michigan and Oklahoma, to increase the number of stores in operation at fiscal year-end to 1,107 in 23 states
- Completion of a major expansion and automation of the Distribution Center in Matthews, North Carolina
- All expansion financed with internally generated funds and the continuance of a balance sheet free of long-term or short-term indebtedness

Fiscal 1986 Operating Results

The record operating results for the year ended August 31, 1986, included sales of $487,734,841, representing a 19% increase above sales of $410,088,400 for the prior fiscal year, and net income of $30,510,527 or 9% above net income of $28,006,936 for fiscal 1985. Earnings per share increased to $1.06 for fiscal 1986 compared to $.98 for fiscal 1985. The results for fiscal 1986 benefited

Lewis E. Levine　　Leon Levine

from a gain in income before income taxes of approximately $1.8 million arising from the discontinuance of the Company's pension plan. The effect of this gain was to increase earnings by $.03 per share for fiscal 1986.

The consistently superior operating performance of the Company is illustrated by the fact that in each of the last eleven fiscal years, net return on sales has never fallen below 5% and shareholders' return on average equity has been at least 21%. In fiscal 1986, the net return on sales of 6.3% and shareholders' return on average equity of 23.7% were among the highest in the discount retail industry. For

comparative purposes, in the 1986 performance rankings of ten leading discount store chains, published by The First National Bank of Chicago, the average for net return on sales was 1.9% and for return on shareholders' equity was 11.9%. In the 1986 rankings, Family Dollar placed first in five of the six categories reported by the Bank, including net return on sales and earnings power.

Financial Condition

During the period of rapid expansion in recent years, Family Dollar has continued to strengthen its financial condition. Although the number of stores in operation has more than doubled in the last four fiscal years, and the distribution capacity necessary to keep pace with this store expansion has been added, all capital needs have been financed entirely with internally generated funds. As in prior years, the Company had no long-term or short-term indebtedness outstanding at any time in fiscal 1986.

The financial graphs in this Annual Report illustrate the continued strengthening of the Company's financial position. During the last ten fiscal years, shareholders' equity has increased from $19.9 million to $141.3 million; working capital has grown from $11.7 million to $81.2 million; and total assets have increased from $34.5 million to $217.4 million. In fiscal 1986 alone, shareholders' equity increased $25.6 million; working capital grew by $13.7 million; and total assets increased $40 million.

Dividend Growth

Family Dollar's financial strength and operating performance are reflected in the growth of quarterly cash dividends declared on the Common Stock. Since the initial cash dividend was declared in fiscal 1976, the dividend has been increased in each succeeding year. During this eleven-year period—a time when the Company has been aggressively expanding—the compound annual rate of dividend growth has been approximately 27%. In fiscal 1986, cash dividends declared per share of Common Stock increased 23%, and the annual rate is now $.24 per share.

Store Expansion

Fiscal 1986 produced the largest number of new store openings of any single year in the Company's 27-year history. The 187 new stores that began operations in fiscal 1986 included the first stores in Illinois, Michigan and Oklahoma. At fiscal year-end on August 31, 1986, 1,107 stores were operating in 23 contiguous states. One fact that puts these numbers in perspective, and illustrates the dimensions of Family Dollar's growth, is that the entire chain consisted of only 198 stores in five states at the end of fiscal 1974.

The record for new store openings in a single year generally lasts only until the end of the following year, and fiscal 1987 is not expected to be an exception. Family Dollar plans to open approximately 193 stores in fiscal 1987, including the 36 stores that have been added to the chain between September 1, 1986, and the current date. This aggressive expansion program should result in approximately 1,300 stores in operation by fiscal year-end on August 31, 1987.

Distribution Center Expansion

As new stores open virtually every week, there is a continuing need for additional distribution capacity to maintain the timely and efficient flow of merchandise to a growing chain. In fiscal 1986, the Company completed a major expansion and automation of the Distribution Center in Matthews, North Carolina, which services all stores, and commenced construction of the last phase of this Distribution Center that will increase the size of the facility to approximately 775,000 square feet. When completed next summer, the fully automated facility will effectively meet the Company's distribution needs for the next several years.

". . . the Company has a proven merchandising concept, which will continue to be refined to meet the needs of our customers for good values in low cost, basic merchandise."

Capital expenditures for the expansion of the Distribution Center have been substantial—approximately $13.3 million in total for fiscal 1985 and 1986, and an additional $6.2 million estimated in fiscal 1987 to complete the expansion. The Company also incurred substantial additional expenses in fiscal 1986 in connection with this expansion, including costs during the transition period when the automated system was being phased-in and the manual system replaced, start-up costs of a second-shift operation and higher depreciation and maintenance expense. While some of these additional expenses will continue into fiscal 1987, the Company has begun to realize the efficiencies and productivity the automated system is designed to produce. As the base of stores continues to grow, the Company now has the modern, efficient distribution system that is the necessary foundation to support such growth.

Fiscal 1987 Outlook

While fiscal 1986 was a good year by most standards, we were not satisfied with sales in existing stores which were at the same level as in fiscal 1985. Although the Company had a substantial sales gain in fiscal 1986, the entire gain was attributable to sales in new stores. Existing store sales in fiscal 1986 were impacted by a slowing economy, moderating consumer demand, deflationary trends and an increasingly competitive retail environment.

As part of the Company's efforts to produce meaningful existing store sales gains, we have begun testing a new interior store layout and merchandise presentation that places increased emphasis on apparel and other softline departments. The more prominent and attractive display of softline merchandise has produced encouraging initial sales results, without changing the merchandise mix. All new stores are being opened with this new format and, if the sales results continue to be positive, we will proceed with converting all existing stores to the new format beginning in January 1987. The conversion of the entire chain could be completed by July 1987.

Many of the economic and competitive factors that contributed to a difficult retail sales environment in fiscal 1986 are continuing in fiscal 1987; but there is much to be positive about at Family Dollar. The acceptance by consumers of our merchandising concept presents great opportunities for continued rapid growth in the number of stores in operation. The progress made in expanding and automating the Distribution Center ensures that the stores will be supplied in a timely and efficient manner. Low and low-middle income families who constitute a significant part of Family Dollar's customer base generally should have greater spendable income as a result of reduced tax liabilities under the recently enacted federal tax legislation. And the Company has a proven merchandising concept, which will continue to be refined to meet the needs of our customers for good values in low cost, basic merchandise.

We are grateful for the continued support and encouragement of our shareholders, and again express our sincere appreciation to the more than 7,000 employees of Family Dollar whose talents and dedicated efforts have been responsible for the success of our Company.

Leon Levine

Leon Levine
Chairman of the Board
Chief Executive Officer

Lewis E. Levine

Lewis E. Levine
President
Chief Operating Officer

November 20, 1986

Market Research

A Continuing Focus On Our Customers

Customer Profile

The typical Family Dollar customer is female, between the ages of 25 and 49, and shops for a family with a median annual income of less than $25,000.

"Our customers recognize that Family Dollar's approach to merchandising provides them with the good values they demand for their retail dollars."

Customers

Family Dollar is a focused company. Since the opening in 1959 of the first Family Dollar store, one focal point has been the identification of our customer base. Marketing surveys have told us a great deal about our customers. Most are females between the ages of 25 and 49, who are shopping for a family with a median annual income of less than $25,000. The typical customer shops in a Family Dollar store five times each month and spends about $8.00 on each visit.

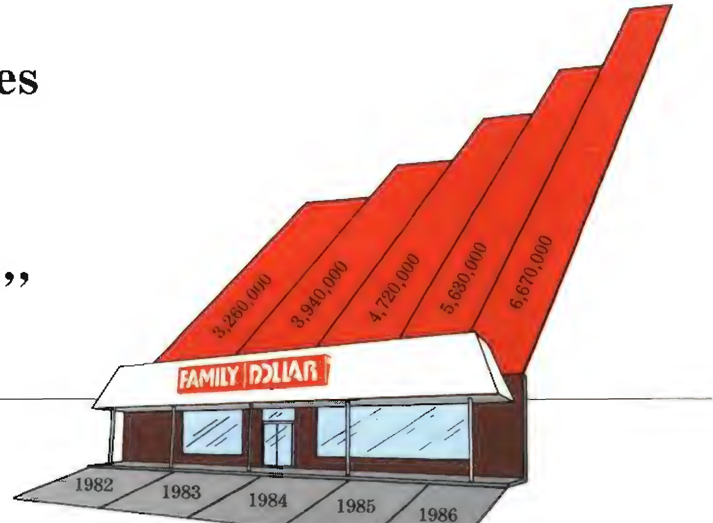
With the customer base clearly established, the next point of focus is identifying the merchandise needs of the customers. Through marketing surveys, our customers have told us that their primary reason for shopping at Family Dollar is the availability of good quality, basic merchandise at low prices. They are relying on Family Dollar to provide the value they must have to stretch their limited disposable incomes.

All aspects of Family Dollar's operations are directed to meeting the merchandise needs of our identified customer base. The merchandise is low priced, with substantially all items in the stores selling at $17.99 or less. With this maximum price concept, a good selection of basic merchandise can be offered within a relatively narrow range of low price points. In order to encourage regular visits by customers, almost all items of basic merchandise are carried on a continuous basis throughout the year. The stores, which are located as conveniently as possible to our low and middle income customers, are self-service, cash and carry, standardized operations with no frills and low overhead. Our customers recognize that Family Dollar's approach to merchandising provides them with the good values they demand for their retail dollars.

Family Dollar does not attempt to be all things to all people, but rather we focus our efforts as a specialty retailer on a well defined segment of the retail marketplace. By not losing sight of who our customers are and how we can best meet their needs, Family Dollar has established a niche in the marketplace that offers great opportunities for continued profitable growth.

Family Dollar has built a broad base of satisfied customers by providing good values in first quality, low cost, basic merchandise for family and home needs.

". . .with approximately 193 new stores expected to open during the current fiscal year ending August 31, 1987, Family Dollar is continuing its aggressive store expansion program."



Square feet of selling space in stores operating as of November 1:

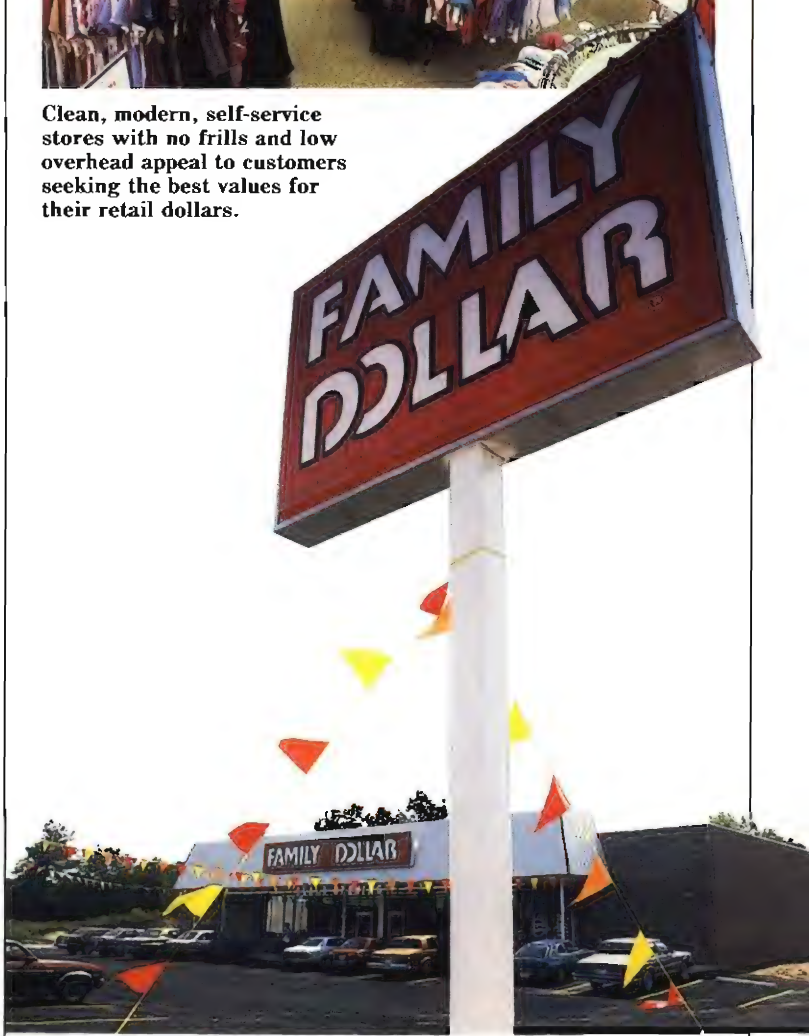
Stores

Family Dollar has pursued an aggressive store expansion program for many years, but the recent pace of new store openings has been accelerating. In the last four fiscal years alone, 578 new stores were added to the chain, representing more than one-half of the 1,107 stores in operation at fiscal year-end on August 31, 1986. During the same four years, Family Dollar's geographic perimeter has spread rapidly. The number of states in which stores are operating has more than doubled, with the first store openings in New Jersey, Delaware, Maryland, Pennsylvania, Ohio, Indiana, Illinois, Michigan, Missouri, Arkansas, Louisiana, Oklahoma and Texas. As the Company has expanded to the north and west, Family Dollar's merchandising concept has been as well received in the new states as in its original southeastern base states.

While the recent pace of new store openings has accelerated, the pattern of expansion remains the same. Family Dollar continues to expand in all directions from our base in North Carolina by opening stores in proximity to our existing stores. The relatively small size of the stores—generally 6,000 to 8,000 square feet of total area—permits them to be tightly clustered. Although more than 60% of the stores are located in communities with populations under 15,000, they also operate profitably in large urban areas, so no markets have to be bypassed. The advantages of clustering stores in locations convenient to our customers is reflected in market surveys showing that approximately one-half of all Family Dollar shoppers live within four miles of a store. By extensively developing each new trading area, Family Dollar establishes a clear identity with our customers and realizes efficiencies in merchandise replenishment, advertising and supervisory controls.

Most of the stores are operated under leases in shopping centers, or as free-standing buildings, with adequate parking facilities available. The merchandise is displayed in uniform interior store layouts, and fixtures and signs are also identical in all stores. By standardizing the stores in every respect, the Company is able to open large numbers of new stores in a timely and economical manner. And with approximately 193 new stores expected to open during the current fiscal year ending August 31, 1987, Family Dollar is continuing its aggressive store expansion program.

Clean, modern, self-service stores with no frills and low overhead appeal to customers seeking the best values for their retail dollars.



"Family Dollar's distribution system contributes toward meeting the needs of our customers by keeping the stores 'in-stock' with merchandise delivered in a cost-efficient manner."

State of the art technology speeds the flow of merchandise through the Distribution Center to the stores.

When completed next summer, the last phase of the expansion of the Distribution Center will increase the size of the facility to approximately 775,000 square feet.

Distribution

A modern fleet of Company tractors and trailers resupplies merchandise to the stores on a weekly basis.

Family Dollar's aggressive store growth has required an equally aggressive expansion of our distribution facilities and systems to ensure that all stores are supplied with merchandise in a timely and economical manner. The Company's Distribution Center in Matthews, North Carolina, has been expanded in several phases and now encompasses approximately 510,000 square feet for receiving, storing and shipping merchandise. The last phase of the expansion has begun, and when completed next summer the automated Distribution Center will contain approximately 775,000 square feet. This facility will then have the capacity to serve approximately 1,700 to 1,800 stores, and effectively meet our distribution needs for the next several years. Almost $20 million will have been expended in the current and last two fiscal years to expand the Distribution Center, including approximately $6.2 million in the current fiscal year. The entire cost has been financed with internally generated funds, and no bank borrowings or other financing will be necessary to complete the expansion.

Substantially all merchandise purchased by Family Dollar's buyers is received at the Distribution Center. Orders for individual stores are filled based on computer generated inventory reports and orders placed directly by the store manager using electronic handheld terminals. Approximately 60,000 cases are loaded for shipment each day. To achieve this flow, case merchandise is picked from storage racks in "batches" of 14 store orders at a time. These cases are placed upon an automated conveyor system that moves through the facility collecting additional cases from multiple picking areas. The cases are conveyed beneath a laser scanner which reads the bar code label on each case at the rate of two per second. The scanner automatically diverts each case to one of the shipping conveyors, which has a telescoping extension directly into the trailer to facilitate rapid loading of the merchandise.

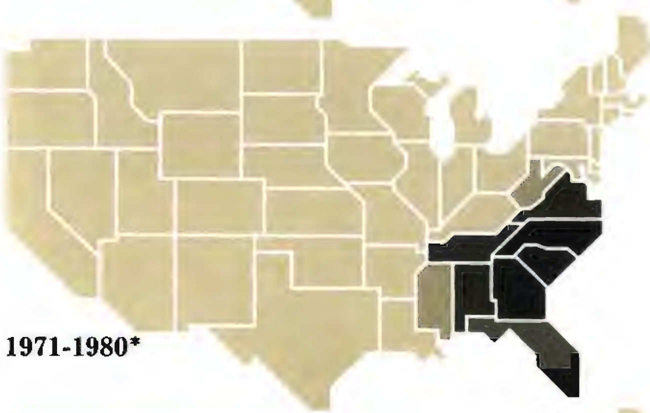
The merchandise is then shipped to the stores primarily on the Company's fleet of tractors and trailers. As Family Dollar's store operations have expanded to the north and west, common carriers are used for deliveries to stores in more distant areas. The stores are resupplied with merchandise on a weekly basis. Family Dollar's distribution system contributes toward meeting the needs of our customers by keeping the stores "in-stock" with merchandise delivered in a cost-efficient manner.

"More than one-half of the 1,107 Family Dollar stores in operation at August 31, 1986, have been opened in the last four fiscal years; and by August 31, 1987, there will be approximately 1,300 stores in operation."

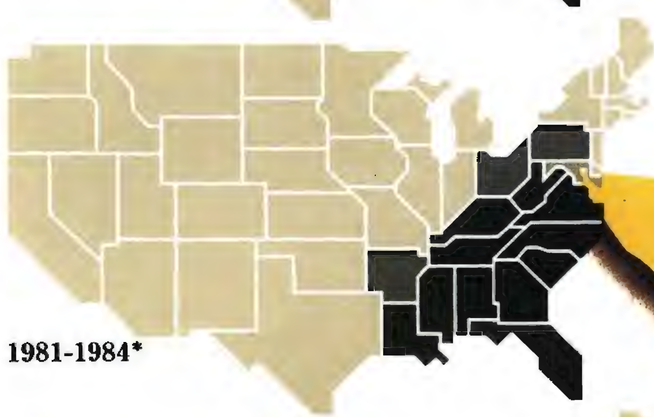
Number of Stores

- 1-5
- 6-20
- 21-50
- 51-99
- 100 +

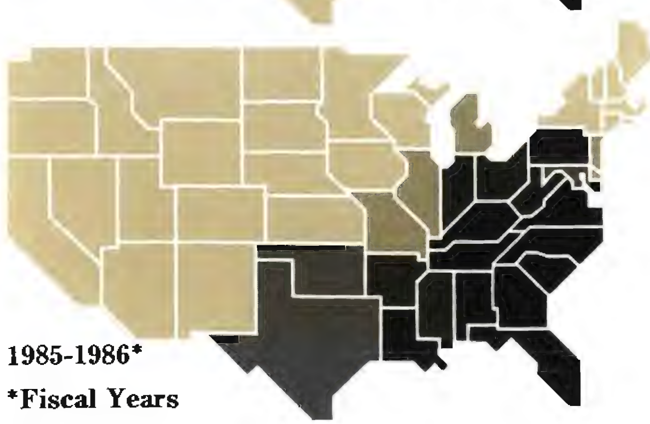
1959-1970*



1971-1980*

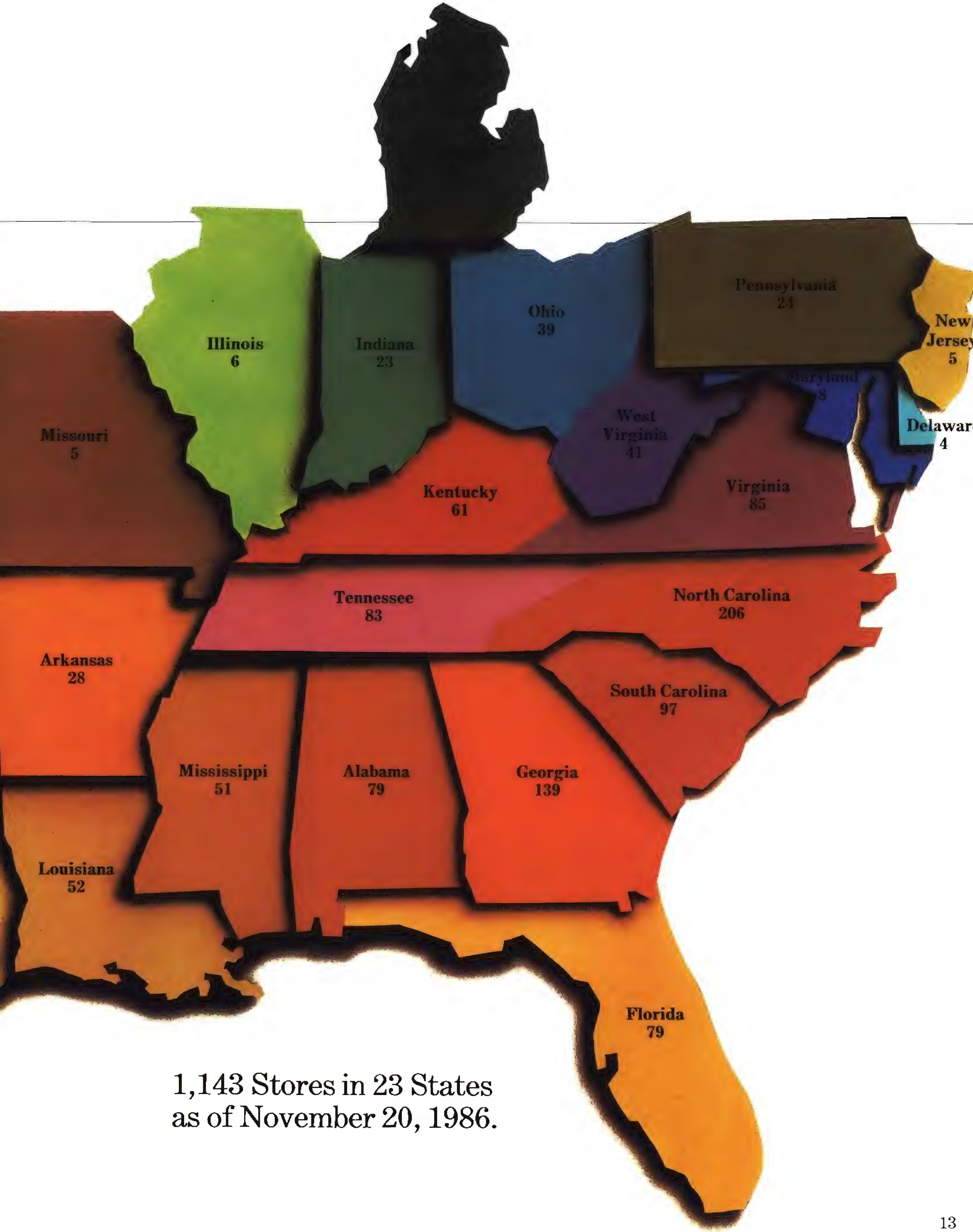


1981-1984*



1985-1986*

*Fiscal Years



1,143 Stores in 23 States
as of November 20, 1986.

Ten-Year Summary of Selected Financial Data

Years Ended August 31,	1986	1985	1984
Net sales	**$487,734,841**	$410,088,400	$340,919,236
Other income	**7,977,378**	5,385,443	5,578,109
Cost of sales and operating expenses	**438,173,118**	363,468,566	302,021,100
Income before income taxes	**57,539,101**	52,005,277	44,476,245
Income taxes	**27,028,574**	23,998,341	20,918,918
Net income	**30,510,527**	28,006,936	23,557,327
Net income per common share	**$1.06**	$.98	$.83
Dividends declared	**$ 6,652,787**	$ 5,367,729	$ 3,338,126
Dividends declared per common share	**$.23**	$.18⅔	$.11⅔
Total assets	**$217,357,689**	$177,382,720	$137,513,770
Working capital	**$ 81,232,316**	$ 67,483,824	$ 58,573,995
Shareholders' equity	**$141,293,677**	$115,678,159	$ 90,999,459

Management's Discussion and Analysis of Financial Condition and Results of Operations

Net Sales

Net sales increased approximately 19% ($77,646,000) in fiscal 1986, approximately 20% ($69,169,000) in fiscal 1985 and approximately 29% ($76,479,000) in fiscal 1984, as compared with the respective prior years. The sales increases for fiscal 1986 and 1985 are primarily attributable to the increase in the number of stores operated by the Company during those years. The sales increase for fiscal 1984 is attributable to both significantly improved sales performances in existing stores and the increase in the number of stores in operation.

Comparable store sales were unchanged in fiscal 1986, and increased approximately 2% in fiscal 1985 and approximately 9% in fiscal 1984, as compared with the respective prior years. In fiscal 1986 and 1985, comparable store sales have been unfavorably impacted by a slowing economy, moderating consumer demand, deflationary trends and an increasingly competitive retail environment. In addition, during the second half of fiscal 1986, a severe drought in the Company's southeastern market area adversely affected customers' disposable income.

During fiscal 1986, the Company increased the number of stores in operation by 187 units, compared to increases of 155 units in fiscal 1985 and 130 units in fiscal 1984. Plans have been announced to add approximately 193 new stores in fiscal 1987, which will bring the number of stores in operation at fiscal year-end to approximately 1,300. Plans for new stores are continually reviewed and are subject to change depending on developments in the economy.

Other Income

Other income increased approximately 48% ($2,592,000) in fiscal 1986, decreased approximately 3% ($193,000) in fiscal 1985 and increased approximately 56% ($1,993,000) in fiscal 1984, as compared with the respective prior years.

Other income consists primarily of interest income on short-term investments and advertising and promotional allowances from vendors. Variances occur from year to year depending on the availability of funds for short-term investments and interest rates thereon, and the extent of vendor participation in promotional and advertising activities.

Other income for fiscal 1986 also includes a gain of approximately $1,844,000 resulting from the termination of the Company's pension plan. This amount represents the amount of plan assets in excess of the vested benefits of participants. The increase in other income excluding this gain was approximately 14% ($748,000).

Cost of Sales

Cost of sales increased approximately 19% ($47,594,000) in fiscal 1986 and fiscal 1985 ($40,717,000), and approximately 26% ($44,182,000) in fiscal 1984, as compared with the respective prior years. Such increases primarily reflect the additional sales volume in each of the respective years. Cost of sales, as a percentage of net sales, was 61.5% in fiscal 1986 and fiscal 1985, and 62.0% in fiscal 1984. Differences in cost of sales percentages are attributable to variances from year to year in the product

1983	1982	1981	1980	1979	1978	1977
$264,440,407	$207,419,020	$181,712,931	$166,854,381	$151,834,382	$117,521,340	$90,585,883
3,585,486	2,622,359	1,964,955	1,590,586	1,401,218	1,167,258	1,015,009
237,788,731	189,669,776	166,154,371	152,580,097	138,557,248	106,687,589	82,408,021
30,237,162	20,371,603	17,523,515	15,864,870	14,678,352	12,001,009	9,192,871
14,510,582	9,676,196	8,406,584	7,528,124	6,941,049	5,849,664	4,503,642
15,726,580	10,695,407	9,116,931	8,336,746	7,737,303	6,151,345	4,689,229
$.55	$.38	$.33	$.31	$.29	$.23	$.17
$ 2,651,574	$ 2,226,431	$ 1,900,525	$ 1,672,067	$ 1,448,880	$ 1,117,644	$ 793,173
$.09⅓	$.08	$.06⅔	$.06	$.05⅓	$.04	$.02⅔
$113,211,892	$ 86,610,803	$ 70,449,093	$ 65,618,547	$ 63,643,008	$ 45,712,599	$34,540,047
$ 43,859,027	$ 33,532,953	$ 26,031,686	$ 18,062,128	$ 10,840,313	$ 12,700,895	$11,685,183
$ 69,956,528	$ 54,979,449	$ 46,368,472	$ 38,593,545	$ 31,535,310	$ 25,108,847	$19,905,420

mix, markdowns, merchandise shrinkage losses, freight costs and to the effectiveness of the merchandise procurement programs. Management presently anticipates that, in an increasingly competitive retail environment, cost of sales as a percent of net sales may increase in fiscal 1987 as compared to fiscal 1986.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased approximately 24% ($27,111,000) in fiscal 1986, approximately 23% ($20,731,000) in fiscal 1985 and approximately 28% ($20,050,000) in fiscal 1984, as compared with the respective prior years. The increases are attributable primarily to additional costs arising from the continued growth in the number of stores in operation, expansion and automation of the distribution center and increased insurance expense. Selling, general and administrative expenses, as a percentage of net sales, was 28.4% in fiscal 1986, 27.1% in fiscal 1985 and 26.5% in fiscal 1984.

Operating costs, including wages, rents, advertising and utility costs, have risen principally as a result of the continued growth in the number of stores in operation. The expansion and automation of the Company's distribution center has resulted in increased depreciation, maintenance and other costs. The Company had increases in rents from $10,271,000 in fiscal 1984 to $13,544,000 in fiscal 1985 and $17,474,000 in fiscal 1986; increases in advertising costs from $7,546,000 in fiscal 1984 to $10,466,000 in fiscal 1985 and $12,652,000 in fiscal 1986; and increases in utility costs from $6,663,000 in fiscal 1984 to $8,505,000 in fiscal 1985 and $10,801,000 in fiscal 1986. Insurance expense increased to $2,543,000 in fiscal 1986 from $1,420,000 and $1,395,000 in fiscal 1985 and 1984, respectively. Management expects selling, general and administrative expenses to continue to rise in fiscal 1987 due to continued store unit expansion, additional expansion of the distribution center and further increases in insurance expense.

Income Taxes

Income taxes increased approximately 13% ($3,030,000) in fiscal 1986, approximately 15% ($3,079,000) in fiscal 1985 and approximately 44% ($6,408,000) in fiscal 1984, as compared with the respective prior years. These increases are primarily due to increases in pre-tax earnings. The effective tax rate was 47.0% in fiscal 1986 and fiscal 1984, and 46.1% in fiscal 1985. Fiscal 1985 benefited from increased investment tax credits related to the expansion of the distribution center. The Company has recognized the benefit of approximately $300,000 in investment tax credits in fiscal 1986 that are not available as a result of retroactive provisions in the recently enacted Tax Reform Act of 1986. In accordance with a proposed Financial Accounting Standards Board Technical Bulletin, the loss of this investment tax credit benefit will be recognized in the first quarter of fiscal 1987.

Liquidity and Capital Resources

The Company has consistently maintained a strong position of liquidity and has the financial strength to meet its regular operating needs, cash dividend payments and expansion program. The cash flow and earnings from the Company's operations are its primary source of liquidity. In addition, the Company maintains a bank line of credit for short-term financing of $25,000,000. There were no short-term borrowings under this line of credit during fiscal 1986, 1985 or 1984, and there were no long-term borrowings during these years. Current operations are expected to generate sufficient cash flow such that no borrowings will be necessary for fiscal 1987. The Company's short-term cash investments declined $10,024,000 during fiscal 1985, principally as a result of the $11,288,000 increase in capital expenditures. Such increase was primarily attributable to the expansion of the distribution center in Matthews, North Carolina at a cost of approximately $9,500,000.

The following table discloses the strength of the Company's liquidity at August 31, 1986, 1985 and 1984:

	1986	1985	1984
Current assets/ current liabilities	**2.2 to 1**	2.2 to 1	2.3 to 1
Working capital	**$81,232,316**	$67,483,824	$58,573,995

Presently planned capital expenditures for fiscal 1987 are principally related to the Company's retail store expansion program, and a 265,000 square foot addition to the distribution center. All capital expenditures will be funded from working capital. The Company occupies most of its stores under operating leases.

Inflation

The inflation rate for all goods, as measured by the Consumer Price Index for all Urban Consumers, and the inflation rate with respect to retail prices, as measured by the Department Store Inventory Price Indexes, have been significantly lower during 1986 and 1985 than in prior years. The virtual absence of growth in retail prices due to inflation requires that the Company carefully monitor its merchandise pricing structure and manage operating costs to achieve improvements in productivity.

Any effects of inflation, estimated by valuing the Company's inventory and property and equipment on a current cost basis, would impact operating results primarily through cost of goods sold and depreciation expense.

Merchandise inventory is the Company's principal asset and component of cost of goods sold. At August 31, 1986, and for fiscal 1986, merchandise inventory and cost of goods sold, adjusted to reflect current costs, would not be materially different from those amounts reported in the fiscal 1986 financial statements.

Capital expenditures during fiscal 1986, 1985 and 1984 represent approximately 65% of the Company's gross property and equipment cost as of August 31, 1986. During this period, the Company has not experienced material, inflation related, cost increases in property and equipment and, as a result, depreciation expense adjusted to reflect current costs would not be significantly different from the amount included in the fiscal 1986 financial statements. When the Company acquires new productive facilities, the increased depreciation which may occur as a result of inflation is expected to be offset by increased productivity and efficiencies.

The Company constantly monitors the utilization of resources in order to maximize the return on its total asset investment and minimize the impact of inflation. The Company plans to aggressively continue its emphasis on total asset management and productivity to counter any effects of inflation on its operating results.

Market Price and Dividend Information

Family Dollar's Common Stock is traded on the New York Stock Exchange under the ticker symbol FDO. At November 1, 1986, there were approximately 3,800 holders of record of the Common Stock. The accompanying tables give the high and low sales prices of the Common Stock and the dividends declared for each quarter of fiscal 1986 and 1985.

Market Prices and Dividends

1986	High	Low	Dividend
First Quarter	$23.00	$19.25	$.05
Second Quarter	22.25	19.38	.06
Third Quarter	27.75	22.25	.06
Fourth Quarter	23.38	21.00	.06

1985	High	Low	Dividend
First Quarter	$19.00	$16.00	$.03⅔
Second Quarter	23.38	15.58	.05
Third Quarter	24.00	20.50	.05
Fourth Quarter	26.88	20.38	.05

Consolidated Statements of Income

FAMILY DOLLAR STORES, INC. AND SUBSIDIARIES

YEARS ENDED AUGUST 31,	**1986**	1985	1984
Revenues:			
Net sales	**$487,734,841**	$410,088,400	$340,919,236
Other (Note 6)	**7,977,378**	5,385,443	5,578,109
	495,712,219	415,473,843	346,497,345
Costs and expenses:			
Cost of sales	**299,840,341**	252,246,786	211,529,926
Selling, general and administrative	**138,332,777**	111,221,780	90,491,174
	438,173,118	363,468,566	302,021,100
Income before income taxes	**57,539,101**	52,005,277	44,476,245
Income taxes (Note 5)	**27,028,574**	23,998,341	20,918,918
Net income	**$ 30,510,527**	$ 28,006,936	$ 23,557,327
Net income per common share (Note 8)	**$ 1.06**	$ .98	$ .83
Weighted average number of shares outstanding during each year (Note 8)	**28,911,348**	28,711,120	28,601,070

The accompanying notes are an integral part of the consolidated financial statements.

Accountants' Report

Board of Directors and Shareholders
Family Dollar Stores, Inc.
Charlotte, North Carolina

We have examined the consolidated balance sheets of Family Dollar Stores, Inc. and subsidiaries as of August 31, 1986 and 1985, and the related consolidated statements of income, shareholders' equity and changes in financial position for each of the three years in the period ended August 31, 1986. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

With our concurrence, the Company has not presented supplementary information regarding the effects of changing prices on the financial statements required by Statement of Financial Accounting Standards No. 33 that the Financial Accounting Standards Board has determined is necessary to supplement, although not required to be a part of, the basic financial statements. The Financial Accounting Standards Board has proposed the elimination of the requirement to present such supplementary information effective for fiscal years ending after March 31, 1987. The Securities and Exchange Commission has concurred with the Company's omission of the required information for the year ended August 31, 1986.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of Family Dollar Stores, Inc. and subsidiaries at August 31, 1986 and 1985, and the consolidated results of their operations and changes in their financial position for each of the three years in the period ended August 31, 1986, in conformity with generally accepted accounting principles applied on a consistent basis.

LAVENTHOL & HORWATH
Certified Public Accountants

Charlotte, North Carolina
October 15, 1986

Consolidated Balance Sheets

FAMILY DOLLAR STORES, INC. AND SUBSIDIARIES

AUGUST 31,	1986	1985
ASSETS		
Current assets:		
Cash	$ 4,713,871	$ 4,524,619
Short-term cash investments (Note 2)	20,298,247	17,198,660
Merchandise inventories	122,498,772	100,784,767
Prepayments and other current assets	3,731,177	2,350,398
Total current assets	151,242,067	124,858,444
Property and equipment (Note 3)	65,603,630	52,339,054
Other assets	511,992	185,222
	$217,357,689	$177,382,720
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 58,562,315	$ 47,653,362
Accrued liabilities (Note 4)	9,441,832	8,208,609
Income taxes (Note 5)	2,005,604	1,512,649
Total current liabilities	70,009,751	57,374,620
Deferred income taxes (Note 5)	6,054,261	4,329,941
Commitments (Note 7)		
Shareholders' equity (Notes 8 and 9):		
Preferred stock, $1 par; authorized and unissued 500,000 shares		
Common stock, $.10 par; authorized 120,000,000 shares at August 31, 1986 and 40,000,000 shares at August 31, 1985	2,935,086	2,926,651
Capital in excess of par	5,517,071	3,767,728
Retained earnings	133,121,025	109,263,285
	141,573,182	115,957,664
Less common stock held in treasury, at cost	279,505	279,505
	141,293,677	115,678,159
	$217,357,689	$177,382,720

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated Statements of Shareholders' Equity

FAMILY DOLLAR STORES, INC. AND SUBSIDIARIES

YEARS ENDED AUGUST 31, 1986, 1985 AND 1984	Common stock	Capital in excess of par	Retained earnings	Treasury stock
Balance, September 1, 1983 (19,285,372 shares common stock; 263,474 shares treasury stock) (Note 8)	$1,928,537	$1,902,619	$ 66,404,877	$279,505
Net income for the year			23,557,327	
Issuance of 70,039 common shares under employee stock option plan	7,004	250,097		
Tax benefit from exercise of options under employee stock option plan		566,629		
Less dividends on common stock, $.11⅔ per share (adjusted for stock split — Note 8)			(3,338,126)	
Balance, August 31, 1984 (19,355,411 shares common stock; 263,474 shares treasury stock) (Note 8)	1,935,541	2,719,345	86,624,078	279,505
Net income for the year			28,006,936	
Issuance of 213,541 common shares under employee stock option plan	21,354	776,947		
Tax benefit from exercise of options under employee stock option plan		1,241,192		
Less dividends on common stock, $.18⅔ per share			(5,367,729)	
Issuance of 9,697,561 common shares as a result of stock split (Note 8)	969,756	(969,756)		
Balance, August 31, 1985 (29,266,513 shares common stock; 395,211 shares treasury stock) (Note 8)	2,926,651	3,767,728	109,263,285	279,505
Net income for the year			30,510,527	
Issuance of 84,349 common shares under employee stock option plan	8,435	482,039		
Tax benefit from exercise of options under employee stock option plan		1,267,304		
Less dividends on common stock, $.23 per share			(6,652,787)	
Balance, August 31, 1986 (29,350,862 shares common stock; 395,211 shares treasury stock) (Note 8)	$2,935,086	$5,517,071	$133,121,025	$279,505

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated Statements of Changes in Financial Position

FAMILY DOLLAR STORES, INC. AND SUBSIDIARIES

YEARS ENDED AUGUST 31,	**1986**	1985	1984
Source of funds:			
Net income	**$30,510,527**	$ 28,006,936	$23,557,327
Add items not affecting working capital:			
Depreciation of property and equipment	**6,754,698**	4,811,058	3,798,458
Deferred income taxes, net	**1,724,320**	1,737,652	891,724
Working capital provided from operations	**38,989,545**	34,555,646	28,247,509
Proceeds from:			
Dispositions of property and equipment	**272,381**	92,835	82,729
Exercise of employee stock options	**490,474**	798,301	257,101
Tax benefit from exercise of options under employee stock option plan	**1,267,304**	1,241,192	566,629
	$41,019,704	$ 36,687,974	$29,153,968
Application of funds:			
Purchases of property and equipment	**$20,291,655**	$ 22,358,874	$11,070,816
Dividends on common stock	**6,652,787**	5,367,729	3,338,126
Increase in:			
Other assets	**326,770**	51,542	30,058
Working capital	**13,748,492**	8,909,829	14,714,968
	$41,019,704	$ 36,687,974	$29,153,968
Summary of net change in working capital:			
Increase (decrease) in current assets:			
Cash and short-term cash investments	**$ 3,288,839**	$(10,278,887)	$ 9,650,458
Merchandise inventories	**21,714,005**	31,294,252	7,337,638
Prepayments and other current assets	**1,380,779**	1,347,062	94,095
	26,383,623	22,362,427	17,082,191
Increase (decrease) in current liabilities:			
Accounts payable	**10,908,953**	14,932,464	1,230,301
Accrued liabilities	**1,233,223**	145,013	1,560,354
Income taxes	**492,955**	(1,624,879)	(423,432)
	12,635,131	13,452,598	2,367,223
Increase in working capital	**$13,748,492**	$ 8,909,829	$14,714,968

The accompanying notes are an integral part of the consolidated financial statements.

Notes to Consolidated Financial Statements

FAMILY DOLLAR STORES, INC. AND SUBSIDIARIES

YEARS ENDED AUGUST 31, 1986, 1985 AND 1984

1. Description of business and summary of significant accounting policies:

Description of business:

The Company operates a chain of self-service retail discount stores.

Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly-owned. All significant inter-company balances and transactions have been eliminated.

Merchandise inventories:

The inventories are stated at the lower of cost (first-in, first-out method) or market, determined by retail prices less percentages estimated to reduce such inventories to cost or market.

Property and equipment and depreciation:

Property and equipment is stated at cost. Depreciation for financial reporting purposes is being provided principally by the straight-line method over the estimated useful lives of the related assets, and by straight-line and accelerated methods for income tax reporting purposes.

Pre-opening costs:

The Company charges pre-opening costs against operations as incurred.

Income taxes:

Investment tax credits are recognized as a reduction of income tax expense in the year they are utilized.

2. Short-term cash investments:

The Company makes temporary investments in short-term money market instruments consisting primarily of notes and commercial paper of bank holding companies and their subsidiaries and obligations of the United States Treasury and municipalities. These investments are stated at cost plus accrued interest, which approximates market.

3. Property and equipment:

	1986	1985
Buildings	$23,730,806	$17,017,151
Furniture, fixtures and equipment	44,242,250	36,927,301
Transportation equipment	7,737,255	6,280,369
Leasehold improvements	6,409,041	4,626,216
	82,119,352	64,851,037
Less accumulated depreciation and amortization	21,755,595	16,583,807
	60,363,757	48,267,230
Land	5,239,873	4,071,824
	$65,603,630	$52,339,054

4. Accrued liabilities:

	1986	1985
Payroll	$5,553,012	$4,946,634
Sales and property taxes	2,975,175	2,419,312
Payroll taxes	913,645	842,663
	$9,441,832	$8,208,609

5. Income taxes:

The provision for income taxes is as follows:

	1986	1985	1984
Current:			
Federal	$22,066,783	$19,352,678	$17,473,339
State	3,237,471	2,908,011	2,553,855
	25,304,254	22,260,689	20,027,194
Deferred:			
Federal	1,508,781	1,520,445	780,093
State	215,539	217,207	111,631
	1,724,320	1,737,652	891,724
	$27,028,574	$23,998,341	$20,918,918

The Company and its subsidiaries file consolidated Federal income tax returns. Deferred income taxes arise principally from the tax effect of timing differences between financial and tax reporting of depreciation.

The following table summarizes the components of income tax expense:

	1986		1985		1984	
	Income tax expense	**% of pre-tax income**	Income tax expense	% of pre-tax income	Income tax expense	% of pre-tax income
Computed "expected" Federal income tax...	**$26,467,986**	**46.0**	$23,922,427	46.0	$20,459,073	46.0
State income taxes, net of Federal income tax benefit	**1,864,625**	**3.2**	1,687,618	3.2	1,439,363	3.2
Investment tax credits and other	**(1,304,037)**	**(2.2)**	(1,611,704)	(3.1)	(979,518)	(2.2)
Actual income tax expense	**$27,028,574**	**47.0**	$23,998,341	46.1	$20,918,918	47.0

At August 31, 1986, the Tax Reform Act of 1986 (Act) had not been enacted. The Act will repeal the investment tax credit as of January 1, 1986, subject to certain transition rules. A proposed Financial Accounting Standards Board Technical Bulletin requires that the aggregate effect of any retroactive provisions of the Act be recognized during the fiscal quarter of its enactment. Therefore, investment tax credits of approximately $300,000, used to reduce income tax expense at August 31, 1986, will not be available upon enactment.

6. Employee benefit plans:

Pension plan:

On August 29, 1985, the Company discontinued its pension plan. Effective upon termination, all participants employed on that date became fully vested and entitled to receive their accrued plan benefits. The Company received regulatory approval from the Pension Benefit Guaranty Corporation and the Internal Revenue Service for discontinuance of this plan, and subsequently distributed vested benefits to participants. Assets of $1,843,625, in excess of such benefits, are being remitted to the Company, and this amount has been reported as other income in the fourth quarter of fiscal year 1986.

Incentive compensation plan:

The Company has an incentive profit-sharing plan whereby, at the discretion of the Board of Directors, the Company may pay certain employees and officers an aggregate amount not to exceed 5% of the Company's consolidated income before income taxes. Expenses under the profit-sharing plan were $805,000, $920,000 and $905,000 for the years ended August 31, 1986, 1985 and 1984, respectively.

Compensation deferral plan:

Effective August 1, 1986, the Company established the Family Dollar Employee Savings and Retirement Plan (Plan), a voluntary compensation deferral Plan, under Section 401(k) of the Internal Revenue Code, available to all eligible employees. At the discretion of the Board of Directors, the Company makes contributions to the Plan which are allocated to participants, and in which they become vested, in accordance with formulas and schedules defined by the Plan. Company contributions to the Plan were $40,610 for the year ended August 31, 1986.

7. Commitments:

Operating leases:

Except for its executive offices and distribution center, the Company generally conducts its operations from leased facilities and also leases certain equipment. Generally, store real estate leases are for initial terms of from five to fifteen years with multiple renewal options for additional five year periods. Certain leases provide for contingent rental payments based upon a percentage of store sales.

Rental expenses on all operating leases, both cancellable and non-cancellable, for the years ended August 31, 1986, 1985 and 1984, were as follows:

	1986	1985	1984
Minimum rentals, net of minor sublease rentals	**$17,182,930**	$13,275,178	$10,006,066
Contingent rentals	**291,566**	268,876	264,803
	$17,474,496	$13,544,054	$10,270,869

Future minimum rental payments required under operating leases that have initial or remaining non-cancellable lease terms in excess of one year as of August 31, 1986, are as follows:

Year Ending August 31,	Minimum Rental
1987	$18,031,532
1988	16,843,572
1989	15,322,169
1990	13,521,206
1991	11,257,448
Thereafter	34,901,896
Total minimum payments required	$109,877,823

Construction commitments:

The Company has commitments under contracts for the expansion of its distribution center. Capital expenditures totalling approximately $8,700,000 are expected to be incurred to complete this expansion. As of August 31, 1986, contracts for approximately $6,515,000 had been entered into by the Company, of which approximately $2,474,000 had been paid or accrued and included in property and equipment.

8. Common stock:

In fiscal year 1985, the Board of Directors declared a three-for-two stock split on January 17, 1985, pursuant to which 9,697,561 common shares were issued on February 22, 1985, to holders of record of common stock on February 7, 1985.

The following summarizes the changes in the number of common shares outstanding and treasury shares held during the years ended August 31, 1986, 1985 and 1984:

	Common Stock	Treasury Stock
Balance, September 1, 1983, before retroactive adjustment for the 1985 stock split	19,285,372	263,474
Issuance of common stock under employee stock option plan	70,039	
Balance, August 31, 1984	19,355,411	263,474
Issuance of common stock under employee stock option plan from September 1, 1984, to February 7, 1985	39,852	
Three-for-two stock split issued February 22, 1985	9,697,561	131,737
Balance after three-for-two stock split	29,092,824	395,211
Issuance of common stock under employee stock option plan from February 8, 1985, to August 31, 1985	173,689	
Balance, August 31, 1985	29,266,513	395,211
Issuance of common stock under employee stock option plan	84,349	
Balance, August 31, 1986	29,350,862	395,211

Net income per common share is based on the weighted average number of shares of common stock outstanding during each year, after giving retroactive effect to the stock split. Exercise of outstanding stock options would have no material effect on earnings per common share.

9. Employee stock option plan:

The Company's 1979 non-qualified stock option plan provides for the granting of options to key employees to purchase shares of common stock at prices not less than fair market value on the date of the grant. Options are exercisable to the extent of 40% after the second anniversary of the grant, an additional 30% annually on a cumulative basis, and expire five years from the date of the grant. Options to purchase 134,665 shares of common stock were exercisable at August 31, 1986.

	Number of options outstanding	Option price per share
Common stock options, September 1, 1984	387,237	$2.23-$21.50
Granted	86,400	15.67- 22.50
Exercised	(213,541)	1.63- 14.17
Cancelled	(47,945)	
Three-for-two stock split effective February 7, 1985	212,103	
Common stock options, August 31, 1985	424,254	2.41- 22.50
Granted	115,500	19.50- 25.75
Exercised	(84,349)	2.41- 14.17
Cancelled	(37,370)	
Common stock options, August 31, 1986	418,035	3.56- 25.75

At August 31, 1986, there were 236,468 shares available for option, and 314,598 shares were available for option at August 31, 1985.

The per share prices of common stock options included above have been adjusted for the three-for-two stock split effective February 7, 1985, with respect to options granted or exercised during the year ended August 31, 1985 and the common stock options outstanding at that date.

10. Line of credit and short-term borrowings:

At August 31, 1986, the Company had available an unused bank line of credit for short-term financing of $25,000,000 with a variable interest rate. Up to $15,000,000 of the line of credit is convertible into a nine-year term loan at the bank's variable prime rate plus 1/8 %.

There were no short-term borrowings during the years ended August 31, 1986, 1985 and 1984.

11. Unaudited summaries of quarterly results:

Unaudited summaries of quarterly results are as follows (Net income per common share gives retroactive effect to the stock split discussed in Note 8):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(In thousands, except per share data)			
1986				
Net sales	$109,119	$132,997	$124,377	$121,242
Gross profit	42,807	49,947	47,875	47,266
Net income	6,217	8,955	7,552	7,787
Net income per common share	$.22	$.31	$.26	$.27
1985				
Net sales	$ 93,113	$111,262	$102,857	$102,856
Gross profit	35,898	41,748	39,941	40,255
Net income	5,779	8,329	7,048	6,851
Net income per common share	$.20	$.29	$.25	$.24
1984				
Net sales	$ 77,258	$ 91,487	$ 82,852	$ 89,322
Gross profit	29,360	33,882	31,905	34,242
Net income	4,821	6,871	5,638	6,227
Net income per common share	$.17	$.24	$.20	$.22

The fourth quarter of fiscal year 1986 includes a pre-tax gain of $1,843,625 from the discontinuance of the Company's pension plan, as described in Note 6 to the consolidated financial statements.

Corporate Information

FAMILY DOLLAR STORES, INC. AND SUBSIDIARIES

Directors and Officers

Leon Levine
Chairman of the Board, Treasurer and Director

Lewis E. Levine
President and Director

Thomas R. Payne
Director
Senior Vice President and Trust Officer,
NCNB National Bank of North Carolina

Mark R. Bernstein
Director
Partner—Poe, Thompson,
Bernstein, Gage & Preston, Attorneys at Law

Howard R. Levine
Senior Vice President-
Merchandising, Advertising and Distribution

George R. Mahoney, Jr.
Senior Vice President-
General Counsel and Secretary

James A. Seagraves
Senior Vice President-
Store Operations

Stephen G. Simms
Senior Vice President-
Real Estate and Construction

Richard H. Griner
Vice President-
Distribution and Transportation

David J. Krause
Vice President-Finance

Robert S. Parker
Vice President-Loss Prevention

Albert S. Rorie
Vice President-Data Processing

Douglas B. Sullivan
Vice President-Real Estate

Phillip W. Thompson
Vice President-Store Operations

Norman B. Weizer
Vice President-Store Operations

C. Martin Sowers
Controller

Daylon W. Powell
Assistant Treasurer

Janice B. Burris
Assistant Secretary

Shareholder Information

Annual Meeting
The Annual Meeting of Shareholders will be held at 2:00 p.m. at the Company's Executive Offices at 10401 Old Monroe Road, Matthews, North Carolina, on Thursday, January 15, 1987.

Executive Offices
Post Office Box 25800
Charlotte, North Carolina 28212
Telephone (704) 847-6961

Shares Listed
New York Stock Exchange,
Ticker Symbol: FDO

Independent Certified Public Accountants
Laventhol & Horwath
Charlotte, North Carolina 28280

Special Counsel
Poe, Thompson, Bernstein,
Gage & Preston
Charlotte, North Carolina 28244

Transfer Agent and Registrar
Manufacturers Hanover Trust Company
New York, New York 10001

Form 10-K
A copy of Form 10-K filed by the Company with the Securities and Exchange Commission for the fiscal year ended August 31, 1986, may be obtained by shareholders without charge upon written request to the Secretary at the Executive Offices.

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FAMILY DOLLAR

10401 Old Monroe Road
Post Office Box 25800
Charlotte, North Carolina 28212